

**Government Cigar Box Accounting:  
Why the Short-Term is Better  
And the Long-Term is Worse**

In 1992, when the elder George Bush was running against Bill Clinton for the Presidency, Clinton hammered Bush for the level of Government deficits, which were a record for the time. When Clinton was elected the deficits began a decline that eventually became a surplus towards the end of his second term.

What was not appreciated by the general public at the time was the fact that much of the elder Bush's deficits were the result of the Savings and Loan Crisis of that period. As the Government took over more S&Ls and acquired property in the process, the outgo was classified as a Government expenditure. When later the properties were auctioned off the resulting cash generated was considered income.

In reality, the Government did not acquire the properties with the intention of keeping them. Therefore, classifying the funds spent as Government expenditures was misleading, as was classifying the subsequent sales as receipts. The real cost to the Government was the net difference between these two figures. Instead of costing the Government the original \$450 billion outlay, the net cost to clean up the S&L mess was less than \$100 billion.

Unfortunately the S&L crisis served as a dress rehearsal for the banking crisis of 2008-09. This time the expenditures were several times the amount of the prior financial panic. However, we do not yet know the net cost of the Government intervention. We do have an announcement that, because of the crises, the Federal deficit approached \$2 trillion.

For the same reasons as before, the deficit will be reduced. As assets such as the General Motors stock held by the Government are sold along with the foreclosed homes, receipts will rise and expenditures decline. This begs a question: is the way the Federal Government accounts for these costs contributing to the sense of panic? Will the ensuing decline give people a false sense of progress?

In the private sector, the acquisition of assets is considered a capital expenditure. The disposal of such assets is considered a reduction of capital assets held. Insurance that covers deposits (FDIC) or loans (HUD, FHA, etc.) is supposed to be self-sustaining over time. If losses exceed capital, an injection of capital is made with the intent of earning a return and the return of capital in the future.

None of these concepts register with Government accounting. When people talk of the trillions Government owes, they do not net the obligations against what the Government owns. In addition, such programs as FDIC insurance are designed to be neutral over time. If losses become excessive then premiums are raised. Over time whatever has been injected by the Government is paid back.

What does the Government own? The Federal Government is the largest land owner in the country. The value of military bases, Government buildings, etc. is very significant. While such assets do not exceed liabilities, the net amount is far smaller than what pessimists promote.

So in the short run the Federal deficit will get better on its own. What it will not do is get better over time. To do this the Government must address the future deficiencies in Medicare, Medicaid and to a lesser extent, Social Security. All three programs are being driven by demographics which are impervious to the economic cycle.

Medicare and Medicaid are the biggest issues. While lifestyle changes would help healthcare expenditures in the short run, the big expenditure is terminal care. An estimated 70 percent of Medicare expenditures occur in the last year of a patient's life. Often these funds are spent without regard to the quality of life of the patient. While Republicans accused the administration of proposing "death panels" to decide a patient's fate, the reality is that many families are not equipped to make decisions when the quality of life becomes problematic. This is truly the elephant in the room of the deficit debate.

Social Security by comparison becomes a far easier problem to solve. Raising the age of retirement to 70 over time reflects the reality that people are living longer than when the program was first implemented. By gradually raising the age, current workers can factor in the changes in terms of their own savings and work choices.

Finally, there is the subject of tax increases. According to one Internet story, 45 percent of households pay no income tax. Many of these do pay payroll taxes, especially the working poor. At the other end, there is the rise of what has been dubbed the HINTS, High Income, No Taxes households. Expect both groups to be a focal point of the 2012 elections.

## **The Economy**

In spite of the shock of higher oil prices, economic activity continues to pick up momentum. Employment levels continue to increase and the unemployment rate declines.

Many employers are using overtime aggressively to delay hiring additional workers until economic trends become more apparent. The rule of thumb often heard is that employers can be passive about adding workers until the unemployment rate falls below eight percent. As the unemployment rate continues to tick down, expect employers to become more aggressive in their hiring plans.

## **Interest Rates**

Interest rates are poised to go up with higher economic activity. As the various Federal stimulus programs are unwound starting in July, expect interest rates to go up as the Federal Reserve takes in funds to pay for assets they will sell or redeem, shrinking the supply of funds in circulation in the process.

The impact on interest rates will occur primarily on the short end of the yield curve. Money market funds will be among the biggest initial beneficiaries. This will also help households whose investment returns on short-term funds have been driven down by the efforts of the Federal Reserve to jump-start the economy.

The initial losers will be the banks which have used low interest rates to drive down the cost of deposits. Expect floating rate loans to be aggressively re-priced as interest rates rise between now and year-end.

## **Inflation**

Inflation has become one of those cosmic forces that no one can see but everyone feels. According to Government data, inflation outside of food and energy is fairly dormant. The problem is that these two factors will act to drive inflation higher. Increasingly food output is being diverted to fuel, driving food prices ever higher.

Longer-term, the fact that China is running out of qualified workers and is facing wage inflation as a result should give the rest of the world pause. More immediately, the earthquake in Japan will result in less auto competition and higher prices from other suppliers, especially at the medium and upper end.

### **The Stock Market**

While overall profit growth remains healthy, there are great divergences opening up between companies and industries. In general, technology is a mixed bag with volume in several industries no longer offsetting price erosion.

Service industries in general are doing well. Rail and air freight transportation is ramping up, while air passenger transportation has been impacted by travel to Japan. Manufacturing in general is doing well, especially firms that export. Farming profits are at record levels. Most forms of energy are prospering with natural gas being stable.

In terms of supply and demand for stocks, there continues to be a great deal of interest among private equity firms to buy companies and take them private. Outside of the Internet there have not been a significant number of stock offerings. This contraction of supply in the face of demand bodes well for stock prices.

Warren M. Barnett, CFA  
April 20, 2011

© 2011 Barnett & Company